



## Early Journal Content on JSTOR, Free to Anyone in the World

This article is one of nearly 500,000 scholarly works digitized and made freely available to everyone in the world by JSTOR.

Known as the Early Journal Content, this set of works include research articles, news, letters, and other writings published in more than 200 of the oldest leading academic journals. The works date from the mid-seventeenth to the early twentieth centuries.

We encourage people to read and share the Early Journal Content openly and to tell others that this resource exists. People may post this content online or redistribute in any way for non-commercial purposes.

Read more about Early Journal Content at <http://about.jstor.org/participate-jstor/individuals/early-journal-content>.

JSTOR is a digital library of academic journals, books, and primary source objects. JSTOR helps people discover, use, and build upon a wide range of content through a powerful research and teaching platform, and preserves this content for future generations. JSTOR is part of ITHAKA, a not-for-profit organization that also includes Ithaka S+R and Portico. For more information about JSTOR, please contact [support@jstor.org](mailto:support@jstor.org).

# California Law Review

---

VOL. VI

MARCH, 1918

Number 3

---

## Misappropriation of Funds by Fiduciaries: The Bank's Liability

---

IN many of its aspects, the subject of the misappropriation of trust funds presents complicated angles of law and fact. The simplicity of the question is not increased when it concerns trust funds on deposit in a banking institution. The determination of the proper attitude that should be observed by a depository bank toward trust funds on deposit with it, having of course due regard to the efficient exercise of its banking functions, is a question plainly fraught with intricate possibilities of law and fact. The difficulty arises from the mass of detail inherent in the administration of practical banking affairs, and the consequent inability of a bank to supervise, in every particular, the various expressions of administrative minutiae.

There can be no doubt that business has a tendency to exaggerate its importance in any legal scheme of regulation. There is present, therefore, the corollary, that the legal rules applicable to the ordinary situation between individuals should be considerably restricted in its scope where commercial activity is concerned. Especially is this feeling present where the activity is of a detailed nature, demanding a supervision to safeguard against legal liability, wholly violative of the ordinary standards and practice of business expedition and economy.<sup>1</sup> The above tendency therefore must be kept within reasonable limits.

---

<sup>1</sup> On the subject of the forged indorsement on a check duly paid by the drawee bank, the English law is more favorable to the banker than the American law. By Statute of 16 and 17 Victoria Cl. 59, § 19, it is provided, in substance, that if an indorsement is forged the drawee bank steps out of the transaction, leaving the drawer as the one who had paid, with the consequent liability of such payment. Practically, the effect would be the same as a maker having paid a note with a forged indorsement. See Ames, *Cases on Bills and Notes*, Vol. II, p. 747.

There is furthermore a feeling on the part of the business world that it has pre-empted progress and that old rules of law are anachronisms and are inapplicable to modern business conditions, merely because the rules are imbedded in history. But it is apparent that rules tested by experience in a previous generation should not be lightly discarded—the rules may be based on principles unaffected by complexity of detail. In the main, however, the banker should be commended for his somewhat ready acquiescence to old rules of law.

The now almost venerable rule of *Price v. Neal*<sup>2</sup> has at times been severely attacked by the courts and by the banking and business interests of the country, as being utterly inapplicable to modern conditions of banking, imposing an unheard of burden on the modern banker. But the soundness of the rule has been thoroughly vindicated by experience and is now a permanent part of our modern business legal code.<sup>3</sup> While the doctrine of *Price v. Neal* is thoroughly sound in principle, the old Illinois rule<sup>4</sup> that a check was a *pro tanto* assignment of funds was hardly supportable in a rural community where business was necessarily very limited. In a business community the rule is exceeding inapplicable. Its abrogation was a decided improvement in the law. A further and striking recognition that the complexity of the banking business requires a more elastic rule of conduct, is afforded by the practical annulment of the rule that subjected a bank to liability *per se* if, through accident or mistake, a customer's check had been returned with the marking "not sufficient funds" or its equivalent.<sup>5</sup>

The multiplicity of detail inherent in modern banking business must be recognized in formulating a rule in regard to the misappropriation of funds in a bank's custody. But as the law on this point has not been developed until a comparatively recent date,<sup>6</sup>

---

<sup>2</sup> *Jenys v. Fawler* (1733), 2 Strange 946. is really the parent of *Price v. Neal* (1762), 3 Burrows 1354.

<sup>3</sup> § 189 N. I. L.

<sup>4</sup> See 2 Illinois Law Review, 144 at p. 157, for comment by Professor Greeley of Northwestern University Law School.

<sup>5</sup> *Marzetti v. Williams* (1830), 1 B. & Ad. 415, sounded the English and now accepted modern view on the question of a bank's liability in mistakenly or otherwise dishonoring its customer's check. The *per se* rule of liability therefore never obtained in England.

<sup>6</sup> New York has reached the highest point of development on the subject, but in some respects not the most logical result in the opinion of the writer.

there is, therefore, no entangling alliance with any rules grounded in a less modern period. The necessity for a rule on this point involves an extensive use of checks, instruments which have not been in popular use for a period longer than twenty-five years. However, to formulate a rule of law which does not impede the proper exercise of the functions of a banker and which at the same time fully safeguards the rights of innocent members of the public,<sup>7</sup> has been no easy task for the courts. Business exigency and the safeguarding of private rights are in many instances irreconcilable, at least from a superficial point of view.

Trust funds in an account with a banking institution are usually held on deposit in the following manner: (1) An account of the fiduciary held with an individual designation, the balance in the account being made up in part or in whole by the deposit of trust funds, known by the bank to be such, or (2) An account of the fiduciary is held with a designation<sup>8</sup> of its character as a trust account.

*Checks payable by the fiduciary to the order of a third person.* Where a check is drawn on such funds by the fiduciary, payable to a third person, the position of the depository bank, in honoring the instrument, is clearly defined. As the Court noted in the case of *Bischoff v. Bank*,<sup>9</sup>

"A bank does not become privy to a misappropriation by merely paying or honoring the checks of a depositor drawn upon his individual account, in which there are, in the knowledge of the banker, credits created by deposits of trust funds. The law does not require the bank under such facts

---

<sup>7</sup> The American Bankers' Association is on record as favoring a greater safeguard in the use of the check, by the enactment of statutes, whereby a depositor, drawing checks and having no reasonable grounds to believe they will be paid when presented, or drawn, is subject to criminal liability. See 9 Journal of the American Bankers' Association, 981.

<sup>8</sup> "J, Cashier," "J, Trustee X Estate," "J, Agent," "J, Executor or Administrator," etc., are designations which give passive notice to a bank that the account so designated, or a check so designated is fiduciary in its nature. Whether an account designated by number as "J account No. 1," or "J. special," etc., is a fiduciary one, depends on the character of funds in its makeup. If made up in currency or checks payable to the individual order of the fiduciary, the account would not be considered of a trust character. However, if such an account were made up in whole or in part of checks payable to the depositor's order in a fiduciary capacity, as "Pay to J, Guardian," the account would be considered as being made up of trust funds. In *Ex Parte Kingston* (1871), L. R. 6 Ch. 632, the designation "Police Acct." was held to be a fiduciary designation.

<sup>9</sup> (N. Y. 1916), 112 N. E. 759.

to assume the hazard of correctly reading into each check the purpose of the drawer, or, being ignorant of the purpose, to dishonor the check. The presumption is, and after the deposits are made, remains, until annulled by adequate notice or knowledge, that the depositor would reserve or lawfully apply the trust funds."

The foregoing rule is therefore understandable and consonant to a sound banking practice. For as the court further stated,

"Although the depositor is drawing checks which the bank may surmise or suspect are for his personal benefit, it is bound to presume in the absence of adequate notice to the contrary that they are properly and lawfully drawn."<sup>10</sup>

*Checks payable by the fiduciary to the order of the fiduciary.*

The cases on this point arise in two ways: (1) Where the depository bank has honored the instrument directly over its own counter to the fiduciary, or where the depository bank has honored the instrument to a holder tracing the title from the payee. (2) Where the depository bank has sanctioned a transfer of funds from a fiduciary account to the personal account of the trustee. The latter situation arises when a fiduciary has two accounts with an institution, one held with a fiduciary designation and one held with an individual designation.<sup>11</sup> The check deposited in the individual account may obviously be payable to the order of the bank, to the order of an impersonal payee as cash or bearer, or to the personal order of the fiduciary and indorsed by him.

The general rule regarding the bank's position in transactions of the foregoing nature is clearly set out in the case of the Fidelity Company v. Queen's County Trust Company.<sup>12</sup> "The mere

---

<sup>10</sup> Accord, *Adm'r. v. Bank* (1900), 194 Pa. 334, 44 Atl. 1064; *Batchelder v. Bank* (1905), 188 Mass. 251, 73 N. E. 1024. Contra, *Adm'r. v. Bank*, (1913), 127 Tenn. 720, 157 S. W. 414; *Eyrich v. Bank* (1889), 67 Miss. 60, 6 So. 615. This is true, although the trust character may have terminated. In *Swartwout v. Mechanics' Bank* (1848), 5 Denio 555, the account was held as "Samuel Swartwout, Collector." After the depositor was no longer collector, the depository bank was held safe in paying checks drawn by Swartwout.

<sup>11</sup> The question would be the same if the transfer were from one bank to another, for instance, if X had a personal account in the "A Bank" and an executor's account in the "B Bank," and drew a check on the B Bank payable to himself or to bearer, or to the A. Bank, and deposited such check with the A Bank in his personal account. *Bischoff v. Bank*, *Supra* n. 9. *Batchelder v. Bank*, *supra* n. 10.

<sup>12</sup> (1916), 159 N. Y. Supp. 954. The transfer of private funds to the trust account is not a suspicious circumstance and notice that the trustee is misappropriating the funds. *Goodwin v. Bank* (1881), 48 Conn. 550.

fact that checks were drawn by the fiduciary upon the account to his personal order would not have given such bank (drawee bank) notice that he was intending to convert the moneys to his own use but that the bank in that case would still have been warranted in presuming that he was not so engaged and did not intend to do so."

The rule that applies to a bank's liability for misappropriated funds, like the hearsay rule of evidence, is largely made up of exceptions. The rule noted is comparatively simple in its statement and application, that a check payable to a third person drawn on fiduciary funds can be paid safely by the drawee bank. Furthermore, that the mere transfer from the fiduciary account to the personal account of the fiduciary, is not a participation or abetting *per se* in the misappropriation. The drawee bank also may safely pay a check drawn on fiduciary funds and payable to the order of the drawer. It makes no difference whether such check is cashed over its own counter directly to the payee or through intermediate channels.<sup>18</sup>

There have been, however, a few exceptions to the foregoing, some well defined, others not, which change the above rules and hold that a bank cannot countenance a transaction which operates as a use of funds for the personal benefit of the fiduciary.

The first of the foregoing exceptions arises where the bank has notice of the misappropriation of the funds by the fiduciary. The rule of notice has been developed into two aspects.

#### THE BANK HAS INITIAL KNOWLEDGE THAT THE FUNDS IN ITS CUSTODY ARE FIDUCIARY IN THEIR CHARACTER.

When the initial knowledge of the fiduciary character of the account is fastened on the drawee, the status of such account would seem to be the same as if the account were separate and distinct in nature, the fiduciary being placed in the same capacity and situation as the signing officer of an ordinary corporation or other signing agent.

Where there has been a diversion of corporate funds by signing officers, the question arises under the following distinct classes of facts:

---

<sup>18</sup> By this statement it is meant that, if such a check is presented through the clearing house to the drawee bank, the bank is not concerned whether or not the drawer is also the payee.

(1) Where the check is payable directly to the corporation, as "pay to the order of the X company." In a case of this kind, if an officer, having authority to transact general business for such corporation, were to deposit the same to the credit of his personal account, such bank receiving the check and crediting the personal account is liable *per se* for misappropriation of funds.<sup>14</sup>

(2) Where checks or other instruments are payable to an officer in a fully descriptive or in a partly descriptive capacity. If an instrument were payable to an officer in a descriptive capacity such as "Pay to A, President of the X Company," it is not clear that a crediting of such an instrument to his personal account is *per se*<sup>15</sup> aiding and abetting a misappropriation; or whether the deposit takes on the status of the ordinary deposit of trust funds in a personal account, as an instrument payable to "B, trustee of X Estate." An ordinary check or other instrument payable to an officer of a corporation in an abbreviated descriptive capacity, as "Pay to A, President," if deposited in a personal account, would seem clearly to take on a status of the ordinary deposit of trust funds in a personal account, as a check payable to "X, agent."

There can be no doubt that if an instrument drawn in the full or partly descriptive form noted above, is used for personal purposes, as giving the same to a bank in payment of a personal obligation held by the bank against such officer, such bank is a participator *per se* in the misappropriation. And if, in the latter

---

<sup>14</sup> The deposit need not necessarily be made to the personal account of the officer depositing, but such deposit may be made to the account of another firm in which the officer may be interested. *Niagara Woolen Co. v. Pacific Bank* (1910), 126 N. Y. Supp. 890. The doctrine of the *Havana Ry. Co. v. Knickerbocker Trust Co.*, 198 N. Y. 422, 92 N. E. 12, that the misappropriation is shifted to the drawee upon paying, has no application here because the drawee has no constructive notice of any kind in regard to the misappropriation.

<sup>15</sup> An individual receiving a check from the signing officer of a corporation, in payment of an individual obligation held against such signing officer, is guilty of participation in the misappropriation. In *Rochester Co. v. Paviour* (1900), 164 N. Y. 281, 58 N. E., 114, the treasurer gave a check signed "Rochester and Charlotte Turnpike Road Co., M. H. Briggs, Treasurer," in payment of an obligation held against him personally. However, in *Goshen Nat'l. Bank v. N. Y.* (1894), 141 N. Y. 379, 36 N. E. 316, the court qualifies the rule in regard to bank drafts and checks. A signing officer on such instrument does not give constructive notice to his creditor that he is misappropriating funds. The bank drafts and checks have a general use in the commercial world, separate and distinct from the ordinary corporate check.

two cases, where the instrument has been deposited in the personal account, a check on such account takes on the same status of the check on any ordinary personal account in which are present trust funds. The rules on this point are developed elsewhere. However, there can be no question that the check payable in any of the three foregoing forms, "F. Mfg. Company,"<sup>16</sup> "A, President of X. Mfg. Company," or "A, President," can be safely cashed by A over the drawee bank's counter, and also can be safely cashed by any intermediate bank.

(3) Where the signing officer of a corporate check is also the payee.<sup>17</sup> The litigation on this point notes the following distinction in the facts. Suppose that X, the treasurer of the Jones Company, draws a check on the A National Bank payable to himself, and signs it "Jones Company by X, Treasurer." X deposits the check to his personal credit with the B National Bank, which, in turn, presents the check through the clearing house to the A National Bank which duly pays it.

The federal rule on this point is to the effect that the onus of ascertaining misappropriation is on the bank first receiving the check.<sup>18</sup> Thus the first receiving bank may be the drawee, and then again it may not be. If the first receiving bank is not the drawee, the drawee upon paying need not concern itself with the fact that the check is payable to the order of the signing officer. The drawee may presume that the check was drawn for duly authorized corporate purposes. Under the federal rule, therefore, the Jones Company cannot recover from the drawee, but has recourse only against the A National Bank which is liable *per se* for abetting a misappropriation. If the check had been deposited with the drawee, the B National Bank, the latter would have been liable *per se* for the misappropriation. The federal rule is a decidedly sensible one and undoubtedly best fitted for the ready despatch of the banker's duties of honoring his customers' checks.

---

<sup>16</sup> Providing the proper officer or agent of the corporation presents the check when payable to the corporation. The agent with authority to deposit has not implied authority to withdraw. *Walker v. State Trust Co.* (1899), 57 N. Y. Supp. 525.

<sup>17</sup> An officer of a bank, having authority to certify in behalf of the bank, cannot bind the bank on a certification of his individual check. *Claffin v. Bank* (1862), 25 N. Y. 293.

<sup>18</sup> *Havana Central Ry. Co. v. Central Trust Co.* (1913), 204 Fed. 546.



The New York rule on this point is developed by the case of *Havana Central Railroad Company v. Knickerbocker Trust Company*.<sup>19</sup> The court announces a peculiar doctrine on this point, namely, that the intermediate bank is liable until the drawee pays the check, and when the drawee bank honors such item, the liability has been transferred to the drawee bank, which stands in the position of being an abettor *per se* in the misappropriation of the corporate funds. The practical effect of the ruling in the principal case is, therefore, that the drawee bank is *per se* liable if it passes such a check to the personal credit of the signing officer, or if it pays such an item through the clearing house or otherwise, although some other party to the instrument has done, what, under ordinary circumstances, would amount to an abetting in a misappropriation of corporate funds.<sup>20</sup> In the event that facts should be present where an intermediate bank has not collected from the drawee, and such drawee refuses to pay, the only effect of the application of the New York rule, is that no recovery can be had against the drawer of such check. The New York rule certainly adds a new element to the drawee's admission when honoring the instrument, namely, that the drawee guarantees to all preceding parties that the instrument involves no misappropriation of corporate funds by the signing officers.

The drawee bank, it would seem, can pay cash with safety to the payee officer, as can also an intermediate bank. As a practical caution, a bank teller should never receive in a deposit to a signing officer's individual credit, a check signed by himself. The teller should advise such officer first to cash such check at the paying teller's department and then deposit the currency. The same caution is also applicable if such a check is to be used to liquidate any personal obligation held by the bank against such signing officer.

In a jurisdiction applying the New York rule, the only safe procedure for a drawee bank to adopt in handling corporate accounts, is to make a provision for the counter signature of some

---

<sup>19</sup> *Supra*, n. 14.

<sup>20</sup> The rule must be considered as limited to those situations where the intermediate bank would ordinarily be guilty of abetting or participating in a misappropriation. If the intermediate bank is not in any way concerned in the diversion, the drawee obviously should not be held in any way liable for the misappropriation.

other official.<sup>21</sup> If a counter signature is present, a drawee or other bank is not concerned with the official character of the payee.<sup>22</sup> Another method of safeguarding the drawee bank, is for such bank to provide at the time the account is opened, that it shall not be concerned with the official character of the payee, whether or not such payee is a signing officer.<sup>23</sup>

But, aside from these questions of misappropriation by corporation officials, when has a bank initial knowledge of the existence of a trust fund?

As the writer has previously noted, the form of the check deposited is not enough to constitute this initial notice. For instance a depositor having an individual account deposits therein checks payable to his order as follows: "Pay to R. J. Peebles or order, Trustee in Bankruptcy for Z." If the fiduciary character noted when the payee is designated will not of itself give this initial knowledge, it follows that notations, etc., on the check, no matter how pregnant with possible notice, such as, "In re estate of X," do not constitute initial notice.<sup>24</sup>

It follows from this that a fiduciary,<sup>25</sup> in opening an account for the bank and stating to the bank that the account will be in the name of a fiduciary, as "X, trustee," or "J, City Treasurer of Chicago," or "J, Agent of Smith Manufacturing Company," will not put a bank on its guard to inquire into the honesty of every

---

<sup>21</sup> The doctrine of the safety given by a counter signature cannot be pushed too far. It is, in all probability, limited to corporate enterprises or to partnership enterprises. In *Squire v. Ordemann* (1909), 194 N. Y. 394, 87 N. E. 435, the check drawn on the trust fund was given in payment of an obligation held by the defendant against one of the executors, although the check was signed by three executors. The court held the creditor liable for abetting a misappropriation.

<sup>22</sup> Corporation by-laws, generally speaking, are not constructive notice to the bank. Such a by-law must be specifically called to the attention of the bank. *Havana Central Ry. Co. v. Central Trust Co.*, supra, n. 18.

<sup>23</sup> A provision of this character may not be sustained; it savors somewhat of an attempt by the bank to evade responsibility for its own negligence.

<sup>24</sup> In *Duckett v. Nat'l Mechanics' Bank* (1897), 86 Md. 400, 38 Atl. 983, the check was payable as follows, "Pay to the order of James Scott, Cashier, for deposit to H. W. Clagett, being the balance of purchase money due him as trustee from John R. Coale," and was held not to be fiduciary in its nature.

<sup>25</sup> The situation of the fiduciary, and of an agent without authority to use the check, should be carefully distinguished. In the latter case there is a misappropriation *per se*. In *Robinson v. Bank*, (1881), 86 N. Y. 404, the check was payable to the trustees and deposited by a trusted agent to his personal account. The court held the ordinary case of a forged indorsement was present.

transaction,<sup>26</sup> where a check is presented payable to the fiduciary's personal order, or whenever a transfer is made from the fiduciary account to the personal account. Furthermore a multiplicity of checks drawn to the personal order of the fiduciary, or numerous transfers from the fiduciary to the personal account do not, because of the numerical strength of such transactions, constitute notice of the diversion of funds.<sup>27</sup>

If the fiduciary character of a fund is not initially brought home to the bank when the instrument deposited in the account bears on its face such a strong designation of its real character as "Pay to J, Trustee of the X Estate," or "Pay to J, Agent of William Nichol," or, when the account is opened, the fiduciary informs the bank the account is to be known as "trustee of," the question might logically be raised, when does the initial knowledge arise concerning the trust character of the funds on deposit?<sup>28</sup>

The first class of cases involving the fastening of notice on the bank that the funds on deposit are actually of a trust character is that in which the fiduciary actually and actively informs the bank to that effect. Opening an account with the designation or the

---

<sup>26</sup> The bank may buy securities from an administrator or executor knowing him to be such, or may lend such administrator or executor money on the securities of the estate, knowing him to be such. Furthermore, a bank is not liable if the executor misuses or appropriates the proceeds of the sale or loan, although such funds are deposited to the credit in the personal account. *Leitch v. Wells* (1872), 48 N. Y. 585. *Goodwin v. Bank*, supra, n. 12. But a bank cannot buy securities from a trustee, knowing him to be such or lend him money with the securities as collateral, unless the trust instrument gives the above rights. The trust instruments, obviously, should be examined by a bank to ascertain the trustee's rights. *Bank v. Bank* (1898), 156 N. Y. 459, 51 N. E. 398, and cases there cited. See further *Duncan v. Jaudon* (1872), 15 Wall. 165, 21 L. Ed. 142.

<sup>27</sup> *Town of East Chester v. Mt. Vernon Trust Co.* (1916), 159 N. Y. Supp. 289.

<sup>28</sup> *Duckett v. Bank*, supra, n. 24, is sometimes noted as laying down the rule that a check payable to a trustee and deposited in a personal account, will render the bank liable *per se* for misappropriation, irrespective of the form of the drawer's checks. But the distinguishing feature to be noted in the *Duckett* case is that the bank had received instructions from the drawer of the check to credit the "trustee account." The bank had no trustee account, so the bank credited the personal account. The check was not deposited by the trustee himself. The court said, "It is no answer to say that had the bank obeyed the directions given to it and had it opened an account in the name of Clagett as 'trustee' and credited the account with these funds, still Clagett could have withdrawn them on checks appropriately signed and could have misapplied the money without involving the bank in any liability." See *Bank v. Mining Co.* (1896), 165 Ill. 103, 46 N. E. 202, on the subject of strict obedience to instructions of the deposit of funds.

description of a fiduciary nature, or depositing checks payable to a fiduciary,<sup>29</sup> is merely a passive notice by the fiduciary to the bank of the trust character of the funds deposited, and as the writer previously noted, the bank need pay no attention to the passive information.<sup>30</sup>

The first of these cases which involves the doctrine of active notice is where the fiduciary makes a definite statement to the depository bank, concerning the trust character of the funds. The statement is made either at the time of opening the account<sup>31</sup> or subsequent thereto, or in reference to a specific check, if depositing a single fiduciary check to his personal account. There is however considerable doubt, that although the fiduciary specifically informs the bank, "this account represents trust funds which belong to a certain estate," or "these funds I hold in trust," whether or not such notice will be sufficient to constitute an active giving of notice.<sup>32</sup> By a somewhat far-fetched inference from the ruling of *Parks v. Knickerbocker Trust Company* such statements as the foregoing might be construed to mean active notice.<sup>33</sup> If such statements would be so construed, the active information may of course be given to any officer or authorized agent of an institution.<sup>34</sup>

---

<sup>29</sup> *Beaver v. Beaver* (1889), 117 N. Y. 421, 22 N. E. 940.

<sup>30</sup> The fiduciary need not describe his capacity as drawer, i. e., he may draw against fiduciary funds held with a fiduciary designation, and sign in a strictly individual capacity. *Munnerlyn v. Bank* (1891), 88 Ga. 333, 14 S. E. 554.

<sup>31</sup> A deposit by an individual, savings or otherwise, of his own funds, designating himself as trustee for another person, will not of itself render the account one having trust characteristics. *Beaver v. Beaver*, *supra*, n. 29. The death of the self-designated trustee does not affect the right of the administrator to withdraw. *Boone v. City Savings Bank* (1881), 84 N. Y. 85.

<sup>32</sup> The facts constituting active notice in the principal case were very strong, viz., "funds to be held by plaintiff (fiduciary) solely as treasurer of said Association and as its property." But if J were to deposit funds in a bank and inform the bank that the funds were to be withdrawn under the following form, "A Mfg Co., by J. Treasurer," the case of initial notice would seem to be clear.

<sup>33</sup> (1910), 122 N. Y. Supp. 521. In *Walker v. State Trust Co.*, *supra* n. 16, the question of original notice was more clearly set out. The original account was in the name of the minor and later changed by the guardian to the account of "Winchell, Special Guardian." But, as a matter of fact, the withdrawal from the original account was not made by authority, and the funds in the account of Winchell, Special Guardian, never were legally held by Winchell.

<sup>34</sup> Knowledge of a duly authorized clerk is the knowledge of the bank. See *Duncan v. Jaudon*, *supra*, n. 26.

The distinction between active and passive notice hinted at in the decisions, has not been very fully developed, probably due to the difficulty of procuring satisfactory evidence on the point.<sup>35</sup> The decisions in which the distinction was urged did not involve the question of misappropriation, but arose on some other point, for instance, the right of the bank to discharge the liability by a payment to the beneficiary and ignoring the fiduciary. The writer is of the opinion that the distinction between active and passive notice is nice, but not altogether sound. The proper application of the doctrine of active notice, as affecting a bank's liability for the fiduciary's misappropriation, should be limited to the situation where the account is opened in a capacity other than the descriptive capacity.

Where a bank has been designated a depository by an order of court and has accepted such designation, the bank has active notice of the trust character of the account. If the court order provides that the checks drawn on such funds are to be countersigned by the judge, or that some other marking should be used on the check, the character of the fund is more forcefully and actively brought home to the notice of the bank.<sup>36</sup> But if such funds are deposited without the bank's knowledge of the court order, such court order is not given the effect of active notice. In other words, the mere fact that a court order exists is not considered as involving the doctrine of constructive notice, or involving an application of the maxim "*Ignorantia juris excusat non.*"

In *Fidelity and Deposit Company v. Queen's County Trust Company*<sup>37</sup> the court discussed the effect of notice given by Rule

---

<sup>35</sup> In *Van Alen v. Bank* (1873), 52 N. Y. 1, the depositor notified the bank, when depositing in his special account, that the funds belonged to and were for the use of another person and were the proceeds of certain bonds sold. In *Cohnfeld v. Tanenbaum*, (1903), 176 N. Y. 126, 68 N. E. 141, the guardian, at the time of opening up his account, filed the guardianship letters with the bank. However, as all the checks were presumably drawn payable to third persons, the question of misappropriation, as it affected the bank, never was in issue.

<sup>36</sup> In *Bank v. Bank* (1907), 129 Ga. 126, 58 S. E. 867, the court order of which the depository bank had due notice provided that the checks drawn by the receiver should be countersigned by the judge of the court, except checks drawn for expenses, which were to be designated as drawn for that purpose. The drawee bank paid checks drawn by the receiver for personal uses, without such check being countersigned or marked as provided. Held, that the bank had notice that the receiver was misappropriating funds.

<sup>37</sup> *Supra*, n. 12.

29 of the Bankruptcy Rules prescribed by the United States Supreme Court. Rule 29 in substance requires that money of bankrupt estates can be drawn from a depository bank only if countersigned by a clerk of the court. In the particular case under discussion, the bank had sufficient passive notice of the character of the funds deposited with it by the trustee in bankruptcy. But as no notice of the court rule or notice of the court order was served on the bank, the Bankruptcy Rule 29 had the same status as an order of court. In other words, the doctrine of "*Ignorantia juris excusat non*" has no application, and, in the absence of a designation and notice of such designation to the depositor, the rule of court or order of the court merely takes on the status of passive notice.<sup>38</sup>

There can be no doubt that if there were a statute or ordinance to the effect that withdrawals should be made in a certain manner, or that a public fund should be given a certain designation, the fund deposit would take on a fiduciary character and the statute or ordinance would be considered as active constructive notice.<sup>39</sup>

The second aspect of the doctrine of notice assumes that the fiduciary character of the account is only known passively by the bank. Furthermore, the second aspect is predicated active notice of the misappropriation.

**THE BANK HAS NOTICE THAT THE FUNDS ARE BEING  
MISAPPROPRIATED BY THE FIDUCIARY.**

As previously stated the fact that the fiduciary is transferring

---

<sup>38</sup> If a depository is designated by the court and such depository accepts the designation, it is bound by a stipulation for "countersignature on checks withdrawing court funds." All court funds, however, can be bulked by a depository. Separate accounts need not be kept by the bank. *Dodge v. State Nat'l. Bank* (1887), 124 Ill. 464, 14 N. E. 657, carried on appeal to U. S. Supreme Court (1888), 124 U. S. 333.

<sup>39</sup> On the question of public funds, there are, in the writer's knowledge, no statutory provision whereby certain characteristics are given to public funds on deposit in a bank, or that certain formalities must be observed before the official depositing can withdraw such funds. The protection for the public lies in the statutory measures providing that such officials must give sureties for the due safeguarding of the funds. But see discussion in *Perley v. County of Muskegon*, (1875), 32 Mich. 132, in regard to statutory interference with the common law rule of public funds. An ordinance reading "No money shall be drawn out of the city treasury except on a written order of the Mayor, addressed to the treasurer and countersigned by the city clerk," was held not to have any bearing on city funds on deposit in the bank, and that the city official in whose account the same was held could draw on such account in his own individual signature. *Newburyport v. Spear* (1910), 204 Mass. 146, 90 N. E. 522.

funds to his personal account either from the fiduciary account or depositing the fiduciary funds directly in his personal account does not constitute notice, although it is a suspicious circumstance pointing out that the fiduciary is misappropriating the funds. Furthermore, the fact that a fiduciary may make checks payable to himself is not notice. As stated by the court in *Fidelity and Deposit Company v. the Queen's County Trust Company*,<sup>40</sup> "The depository bank is not bound from the mere form of the check, viz., being payable to the depositor's individual order, to take notice that the depositor being a trustee of the funds, is thereby intending to divert the moneys to other than the trust purpose, but must have some other notice of such fact in order to be charged therewith."

The question arises what is meant by the expression "some other notice." Suppose a situation such as the following: The depositor is the executor of an estate and has an "executor's account" with the drawee bank. The depositor has been cashing checks payable to his own order and has been actually using the funds so obtained for private purposes. If such fact is brought to the notice of the drawee bank by persons interested in the estate, has the bank the right to presume that the fiduciary will continue to apply the funds to their proper uses under the trust, and continue to honor other checks drawn to his personal order? Or suppose another situation: The drawee bank ascertains, through indirect channels, that the fiduciary is diverting the funds for personal uses, by paying personal debts with checks drawn on the trust funds. Under the latter situation, is the drawee put on notice that all subsequent checks drawn by the depositor are a diversion of trust funds? Or would this indirect notice operate only in regard to checks payable to the depositor's personal order or to transfer from the fiduciary account to the personal account?

The *cestui que trust* can no doubt give binding notice to the bank that the fiduciary is diverting the trust funds. If notice is given, the presumption may be that the bank can safely honor checks drawn payable to third persons,<sup>41</sup> but could not safely pay

---

<sup>40</sup> *Supra*, n. 37.

<sup>41</sup> But under the doctrine of *Bischoff v. Bank*, *supra*, n. 9, the bank cannot pay any checks, whether drawn to the order of a third person or not, unless it actually ascertains that such checks are drawn for fiduciary purposes.

checks drawn to the fiduciary's personal order, either over the counter or otherwise,<sup>42</sup> and could not countenance a transfer of funds from the fiduciary to the individual account. Furthermore, there can be no doubt that the persons beneficially interested can maintain an equitable action to restrain further payments of any sort by the fiduciary, or can collect the amount in the account.<sup>43</sup> But casual notice, received through channels other than the ones noted above, of the fact that the fiduciary is misappropriating, will not probably be considered sufficient to render a bank liable in paying checks drawn in any form.<sup>44</sup>

However, the question of notice ordinarily arises in connection with an attempt by the bank in which the check is deposited (this bank may be either the drawee bank or some other bank) to liquidate the personal indebtedness of the fiduciary to it, out of the fiduciary fund.

Special situations arise.

*The charge is made directly to the fiduciary account.* To illustrate, the depositor is indebted to the Z bank on a note or on an overdraft. The depositor has an account with the Z bank known as "X, special account," or "X, executor account." The Z bank charges such note or a check covering such note or the overdraft of his personal account, to the account that is specially designated as fiduciary in its nature.

With such a case as the above there is no difficulty, as the diversion and the participation in the diversion by the Z bank is clearly set out. In *National Bank v. Insurance Company*, the court distinctly repudiated any notion that an account which is merely *descriptio personae* (for instance, an account held as

---

<sup>42</sup> Accord, *Van Alen v. Amer. Nat'l. Bank*. Supra, n. 35.

<sup>43</sup> *National Bank v. Insurance Co.* (1881), 104 U. S. 54, 26 L. Ed. 693. In *Co. of Essex v. Newark City Nat'l. Bank* (1891), 48 N. J. Eq., 51, the court entertained a bill to compel the depository bank to transfer funds deposited to the credit of "J. M. Smith, Collector," to Smith's successor in office, Smith having refused to sign a check covering the fund. The court ruled that mandamus was not the proper form of action, but that a bill in equity was the correct method to use to transfer trust funds.

<sup>44</sup> There are dicta in the cases to the contrary. "A bank receiving a deposit from one acting in a representative capacity cannot justify a payment to him of the amount deposited, if it knows, or facts are presented which, if acted upon, would disclose that the fund is about to be wrongfully and unlawfully diverted from the true owner." *Parks v. Knickerbocker Trust Co.*, supra, n. 33. But contra to the above, *Eyrich v. Bank*, supra, n. 40.



"X, general agent") can be used as a basis of a grant of personal credit or in any way estop the beneficiaries from inserting their equities in such fund.<sup>45</sup>

*The charge is made to a personal account into which has crept fiduciary funds.* There are two ways by which the balance in the personal account can be increased by the deposit of trust funds. The first method is by direct transfer from one account to another. As previously noted, this transfer may take place from the fiduciary account to the individual account where both accounts are held in the same bank, or, the transfer may take place where the personal account is held in one bank, and the fiduciary account is held in another bank. The second method by which the balance in the personal account can be increased is where the fiduciary deposits directly in his personal account checks or other instruments drawn to his order in his trust capacity,<sup>46</sup> for instance, a check drawn payable to "R. J. Peebles, Trustee in Bankruptcy for M. T. Bailey, Bankrupt." In principle, the methods of increase in the balance of the individual account are the same.

But if a personal note or other personal obligation of the fiduciary is held by the bank and is liquidated by a check or a charge to the account that is made up of fiduciary funds, the bank is deemed to be the participant in the misappropriation and is

---

<sup>45</sup> Supra, n. 43.

<sup>46</sup> The court in *Bank of Hickory v. McPherson* (1912), 102 Miss. 852, 59 So. 934, lays down the doctrine that a check payable to "O. S. McPherson, Commissioner" cannot be deposited by the fiduciary to his personal account, and that a bank receiving such check and crediting it to the personal account of the fiduciary is liable for misappropriation. It follows, therefore, that the prudent way to handle such transaction is to credit the item in a trustee or special account. However, under the doctrines of the principal case, a bank could not logically sanction a direct transfer from a fiduciary to a personal account. The court purports to base its decision on the Duckett case, supra n. 27, but the facts of the two cases are readily distinguishable. In the Duckett case, the drawer (not the fiduciary) who deposited the check explicitly instructed the depository bank to credit the check to the trustee account. The ruling in *U. S. Fidelity and Guaranty Co. v. People's Bank* (1913), 127 Tenn. 720, 157 S. W. 414, is an out-and-out ruling that a check of a fiduciary nature is an abetting *per se* in the misappropriation by the bank, rendering the bank liable. The court intimates that the correct method to use in handling the transaction is for the bank to credit to a separate account. However, the court notes strongly that a transfer from a fiduciary to a personal account is an abetting *per se* of a misappropriation by the bank.

liable for such misappropriation to the beneficiary of the funds.<sup>47</sup>

The state of the personal account at the time of the charge to it of the personal obligation of the depositor must be kept in mind.

To illustrate:

*J. J.*

<i>Dr.</i>		<i>Cr.</i>	
5-15-17 personal check.....	\$400.00	4-1-17 Dep. in Currency.....	\$200.00
5-18-17 personal note <sup>48</sup> held by bank or check covering such note.....	250.00	5-1-17 Check payable to J. J. as Trustee or check payable to J. J. and signed by J. J. as trustee .....	200.00
		5-3-17 Dep. in Currency.....	300.00

From the state of the above account, there cannot be any question of a participation or of a diversion by the bank, because at the time of the charge there were no trust funds to be diverted. It is apparent that such trust funds that had been deposited had also been lawfully withdrawn.

If the account were in the following state, the bank would be a participant in the misappropriation to the extent of \$400.00:

*J. J.*

<i>Dr.</i>		<i>Cr.</i>	
5-15-17 Personal check.....	\$200.00	4-17 Dep. in Currency.....	\$200.00
5-18-17 Personal note held by bank .....	450.00	5-10-17 Check payable to J. J. as Trustee .....	200.00
		5-10-17 Check payable to J. J. signed J. J. Trustee .....	200.00
		5-20-17 Dep. in Currency.....	200.00

On the question of notice of misappropriation where the fiduciary has attempted to divert trust funds to the liquidation of his individual debt, the case of *Bischoff v. Yorkville Bank* sounds a distinctly new doctrine on the question.<sup>49</sup> The doctrine enunciated by the court is to the effect that the attempt by the fiduciary to use trust funds to discharge a personal debt owing to the bank will operate to give notice to the bank, not only that this

<sup>47</sup> *Gerard v. McCormick* (1891), 130 N. Y. 261, 29 N. E. 115; *Brookhouse v. Publishing Company* (1905), 73 N. H. 368, 62 Atl. 219.

<sup>48</sup> If a bank has an item for collection and receives a check drawn on fiduciary funds in payment thereof, the item for collection is treated as having the same characteristics as if it were actually owned by the bank in its own right. *Lowndes v. City Nat'l. Bank* (1909), 82 Conn. 18, 72 Atl. 150.

<sup>49</sup> *Supra*, n. 9.

particular transaction is a notice of diversion, but also that future transactions of a character, which standing by themselves were not misappropriations, now take on the character of misappropriation of trust funds in which the depository bank is an abettor.<sup>50</sup>

The doctrine of the case is best illustrated by the state of the following account:

*J. J.*

<i>Dr.</i>		<i>Cr.</i>	
4-15-17 Check personal .....	\$200.00	4- 1-17 Deposit check signed	
5- 1-17 Personal note or		by J. J. as Trustee.....	\$200.00
check covering per-		4-10-17           "	300.00
sonal note held by the		5- 2-17           "	200.00
bank .....	300.00	5- 5-17           "	200.00
		5-18-17 Check payable to J. J.	
		as Trustee.....	200.00

The court said in regard to the charge of May 1:

"The presumption that he, the fiduciary, would thus violate his duty and lawful right, that he would apply the moneys to their proper purposes, then ceased to exist. There was absolute proof in the possession of the defendant (i. e. the payment of the personal obligation from trust funds) to the contrary. The defendant had no longer the right to assume that in paying the checks of the fiduciary it was paying executor's money to the executor, and not to the executor the individual, or that the executor would use the moneys lawfully. It had knowledge of such facts as would reasonably cause it to think and believe that Poggenburg (the executor) was using the moneys of the executor for his individual advantage and purposes."

The court therefore held that not only the three hundred dollars could be recovered by the beneficiary, (the amount of the personal debt held by the bank), but also the deposits of May 2, 5 and 18. However, the two hundred dollars could not be recovered as the doctrine of notice which arises from the debit of May 1 is prospective only, and not retro-active in its nature.

The ruling of this case, fairly construed and applied, in principle covers the following states of fact, which in the event of no participation of the bank in the diversion, would render the

---

<sup>50</sup> Contra: *Allen v. Puritan Trust Co.* (1912), 211 Mass. 409, 97 N. E. 916, where the court held that the bank was only liable for the actual participation, i. e., the checks of the fiduciary account which were used to make good the overdrafts in the personal account. The writer is of the opinion that the limitation in the above case is more in harmony with sound business practice than the New York ruling.

bank liable for the actual misappropriation by the fiduciary.

First: The depository bank is liable for the sums in the personal account that are made up from deposits which are transfers from the fiduciary account to such personal account, whether both accounts are in the same bank, or whether the personal account is held in one bank and the fiduciary account is held in another bank.

Second: The depository bank is liable for sums in the personal account that are made up from the direct deposit of fiduciary funds, for instance, the checks drawn payable to the fiduciary as such, and deposited directly in the personal account.

The status of the depository bank, when it honors checks drawn by the fiduciary on trust funds, after the depository bank has received notice of the fiduciary misappropriation under the ruling of the *Bischoff* case, is somewhat in doubt. Although no checks drawn against the account, no matter to whomsoever such orders may be payable, can be safely paid outright by the drawee bank,<sup>51</sup> the point is whether such subsequent payments are made at peril, or whether the drawee bank may absolve itself from liability by showing that it has instituted a reasonable inquiry as to the propriety of the disbursement. The answer is not clearly set forth in the decision. The question however is a somewhat academic one, for as a practical matter, no bank would institute inquiry under the circumstances outlined, but would forthwith refuse to honor any checks drawn by the fiduciary.

However, if the personal account is in fact made up from trust funds which have no ear marks of a fiduciary nature,<sup>52</sup> as a deposit

---

<sup>51</sup> A question of the following nature might well be raised under the doctrine of the *Bischoff* case. The depositor has two accounts with the same bank and transfers funds from the fiduciary account to the individual account, later giving a check on the individual account in payment of a personal obligation to the bank. After such check is given on the personal account, are all checks, of whatever kind, drawn on the fiduciary account paid by the bank at its peril? Or shall the doctrine be limited only to transfers of funds from the fiduciary to the personal account, or to other fiduciary funds that find their way to the personal account? The writer is of the opinion that the doctrine should be limited to the transfers to the personal account.

<sup>52</sup> But see *U. S. Yards Bank v. Gillespie* (1890), 137 U. S. 411, 34 L. Ed. 724, 11 Sup. Ct. Rep. 118, where the bank had an overdraft on which it applied a deposit, the check in the deposit being made payable to the depositor without any marks of a descriptive character. The only notice that the bank had of the fiduciary character of the check deposited was that the depositor was a commission merchant.

of "currency," or checks and other instruments payable to the order of the fiduciary in his personal character with no marks of a descriptive nature, then a depository bank can act as if there were no funds in fact present in the fiduciary account and consider the account as purely a personal one.<sup>53</sup>

*Frederick Thulin.*

Chicago, Illinois.

---

<sup>53</sup> A lien acquired by a banker on funds on deposit, before notice of the fiduciary character, will be protected. This rule is, of course, based on the assumption that the account, or funds deposited in the account, had no earmarks. *Van Alen v. American Nat'l. Bank*, *supra*, n. 35.